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NATURAL RESOURCES DEFENSE COUNCIL

ORIGINAL

October 28, 2010

Chairman Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

RE: **Draft ACC Policy Statement regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures, Docket Nos. E-00000J-08-0314 and G-00000C-08-0314**

Dear Chairman Mayes:

Natural Resources Defense Council ("NRDC") submits the attached comments on the recent draft Policy Statement by the Arizona Corporation Commission ("ACC" or "Commission") on Utility Disincentives to Energy Efficiency and Decoupling. We commend the Commission on this important effort to remove barriers to successful implementation of the newly adopted energy efficiency standards, which promise huge benefits to customers if achieved.

Thank you for considering these comments to the draft Policy Statement, and for the opportunity to participate in your recent workshops on the matter.

Sincerely,

Laura E. Sanchez
Attorney, Air and Energy Program

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COMMENTS OF THE NATURAL RESOURCES DEFENSE COUNCIL ON THE DRAFT ACC POLICY STATEMENT REGARDING UTILITY DISINCENTIVES TO ENERGY EFFICIENCY AND DECOUPLED RATE STRUCTURES

Docket Nos. E-00000J-08-0314 and G-00000C-08-0314

October 28, 2010

Submitted by Ralph Cavanagh and Laura E. Sanchez

OVERVIEW OF RESPONSE

The Natural Resources Defense Council (NRDC) appreciates the opportunity, on behalf of more than 11,000 Arizona members, to comment on the Arizona Corporation Commission's (ACC) Draft Policy Statement regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures. NRDC was a participant in earlier workshops convened by the Commission on these issues. The draft Policy Statement represents an important step toward realizing the opportunities evident in the workshops and broadly supported by many participants and commentators. Unless otherwise indicated, page references below are to the Draft Policy Statement.

The Commission's very thorough summary of the evidence presented in the workshops reinforces a central point: the newly adopted energy efficiency standards promise huge benefits to customers if achieved, and revenue decoupling is essential to remove a major barrier to success. NRDC agrees with the proposal to adopt decoupling in rate cases, with evaluation and review occurring after an initial three-year period (p. 28). The proposal rightly rejects, as alternatives to decoupling, both fixed cost/variable pricing and lost margin recovery (p. 28). Also, given Arizona's appropriately aggressive long-term energy efficiency commitment, adopting decoupling on a "pilot" basis makes no sense; NRDC agrees strongly that this "would not send appropriate signals and would not demonstrate the requisite commitment to eliminating financial disincentives to the adoption of energy efficiency" (p. 21). The Commission rightly proposes to defer cost of capital issues to a time when there is more experience with the mechanism (draft statement #6, p. 31); we address this issue more fully below. Finally, NRDC believes that the proposal strikes an appropriate balance on issues of weather, economic effects, and frequency of true-ups (p. 29).

COMMENTS ON POLICY STATEMENTS

Unless otherwise indicated, NRDC agrees with the draft Policy Statements as proposed.

Statement #3 addresses the rationale for revenue decoupling and the potential value of performance-based incentives. We recommend replacing "it establishes better certainty of utility recovery of authorized fixed costs" with "it removes the linkage between fixed-cost recovery and energy consumption", and we also recommend removing the suggestion that decoupling and utility financial incentives are alternatives to each other. Ideally, they would supplement each other, since they address different problems. Revenue decoupling eliminates a powerful disincentive for utility engagement on energy efficiency but supplies no upside potential for shareholders; performance-based incentives create an earnings opportunity for utilities that exceed expectations. Since both decoupling and incentives are needed, we recommend replacing "or" with "and" in the phrase "Some form of decoupling **or** utility financial incentives must be adopted in order to encourage aggressive use of demand side management programs (item 3, p. 30).

Statement #6 addresses cost of capital issues potentially associated with decoupling. NRDC agrees with the proposal and adds additional observations in support of the draft recommendation; our only additional suggestion here is to remove the word "significant" from "early implementation of decoupling should precede significant adjustments to cost of capital (p. 31).

Recommendations by other parties for such adjustments did not include any empirical evidence that revenue decoupling elsewhere has changed any utility's cost of capital by "reducing risks." These recommendations overlook both what shareholders give up when utilities lose the capacity to profit from electricity sales increases, and what customers stand to gain from accelerated progress in energy efficiency (and protection from higher utility bills linked to extreme weather). Any gains to utilities in the form of insurance against lower sales are offset by reduced opportunities for financial gains when sales increase, and it seems unreasonable to prejudge how that tradeoff might affect the company's overall risk profile and cost of capital.

Fortunately, commissions typically have not linked revenue decoupling to reductions in ROE. Aside from Maryland and the District of Columbia, we are aware of only two downward adjustments specifically associated with revenue decoupling for an electric utility, and those were the 10 basis point (0.1 percent) adjustments for Portland General Electric and Central Hudson, respectively, that the Oregon Public Utility Commission and the New York Public Service Commission adopted in the first half of 2009 as a severe recession deepened. As to the District of Columbia, although a recent revenue decoupling order reduced PEPCo's ROE by 50 basis points, it also noted pointedly that the company's decoupling application did not include any enhanced energy efficiency efforts.[1]

On the other hand, the Maryland Public Service Commission recently ordered a 50 basis point ROE reduction for PEPCo and Delmarva, subsidiaries of PEPCO Holdings, based on contentions that revenue decoupling reduced financial risks for the utility.[2] In these decisions, the Maryland Commission is an outlier among its peers, most of which have followed the ACC's proposed policy.

Statement #9 on weather normalization draws further support from Pamela Lesh's comprehensive assessment of other states' experience with decoupling, which was discussed at the workshops, and could therefore be strengthened by adding the statement "A clear majority of decoupling jurisdictions agree."[3]

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[1] *See* Pub. Util. Commn of D.C., Case No. 1053, Order No. 15556 (Sept. 28, 2009), at 7.

[2] *See, e.g.*, Order No. 83516 (Aug. 6, 2010) at 55.

[3] See Pamela Lesh, *Rate Impacts and Key Design Elements of Gas and Electric Decoupling Mechanisms: A Comprehensive Review*, The Electricity Journal (October 2009), p. 70.

Statement #12 on the blending of adjustments across customer classes to minimize rate impacts is exactly right, particularly given Arizona's aggressive new energy efficiency targets; any year-to-year fluctuations in class-by-class progress should balance out over time. However, we recommend replacing the phrase "discourage dramatic changes" with "minimize rate volatility;" the rate collars recommended in statement #14 will eliminate any possibility of "dramatic changes" in rates.

Statement #14 should specify that any unrecovered balances will be carried forward for possible recovery in future adjustments, subject to the cap.

ADDITIONAL COMMENTS

Response to the Commission's cover letter, question #1: NRDC believes that the LBNL analysis of energy efficiency benefits is conservative, since it includes no allowance for avoided externalities (see pp. 20-21) and reflects average energy efficiency costs (4.1 cents per kWh for the portfolio and 5.5 cents per kWh for the residential sector) that are on the high side of industry experience.

p. 3: The draft proposal states that "Several states have utilized decoupling as a means of bolstering their energy efficiency efforts . . " But this understates progress significantly; as of October 2010, the count of states that have adopted decoupling for at least one utility stands at 12 states and DC for electricity and 20 states for natural gas.

Respectfully Submitted,

NATURAL RESOURCES DEFENSE COUNCIL

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